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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 735

DON A. DAVIS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 32–39) are reported in 4 T. C. 329. The opinion of the Circuit Court of Appeals (R. 51–56) is reported in 151 F. 2d 441.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 15, 1945 (R. 56–57). The petition for a writ of certiorari was filed on January 12, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer is entitled, under Section 23 (a) (2) of the Revenue Act of 1936, as amended by Section 121 of the Revenue Act of 1942, to deduct selling commissions and registration expenses as ordinary and necessary expenses or whether such sums are capital expenditures, and so not deductible from gross income.

STATUTE AND OTHER AUTHORITIES INVOLVED

The applicable statute and other authorities involved are set out in the Appendix, *infra*, pp. 11–20.

STATEMENT

The findings of the Tax Court, so far as pertinent here, are as follows:

On January 1, 1916, the petitioner purchased the controlling interest in the Western Auto Supply Company, a Missouri corporation organized in 1914, and has been its principal stockholder and officer since 1916. At the beginning of the year 1937, this company had outstanding 130,456 shares of no par, nonvoting Class A common stock and 100,000 shares of no par, voting Class B common stock. The latter stock was never listed or admitted to trading on any stock exchange. In March, 1928, the Class A common stock was admitted to unlisted trading privileges and was bought and sold on the New York Curb Exchange

up to and including the month of April, 1937. (R. 32–33.)

On April 5, 1937, the petitioner owned of record, 14,845 shares of the Class A common stock and 41,467 shares of the Class B common stock. He could not sell this stock to the general public through an underwriter or distributor of securities unless a registration statement was in effect with respect to such shares since, due to the Securities Act of 1933, no underwriter would purchase such shares for resale, in view of the petitioner's voting power (right to vote for election of directors of Western Auto). (R. 33.)

On or about April 5, 1937, Western Auto was recapitalized under a plan whereby each share of its outstanding stock, consisting of Class "A" and Class "B" common stock, was converted into three shares of new common stock having a par value of $10. On or about March 4, 1937, there was filed with the Securities and Exchange Commission, Washington, D. C., a registration statement covering 126,000 shares of the above-mentioned new $10 par common stock of Western Auto, and pursuant to subsequent amendments to this statement the registration was effected. The petitioner owned 60,000 of the shares covered by the registration. (R. 33–34.)

During the taxable year 1937, the petitioner paid Western Auto $5,000, which was his portion

of the following expenses incurred in connection with the registration of the shares (R. 34):

Counsel fees	$10,000.00
Fee of Auditors	2,000.00
S. E. C. registration fee	367.50
Registration or qualification under State Blue Sky laws	3,000.00
Printing	6,000.00
Miscellaneous expenses, including postage, telephone and telegraph charges, traveling expenses and other out-of-pocket expenses	6,000.00

Pursuant to a contract dated March 31, 1937, the petitioner engaged the services of a group of underwriters to offer to the public, at $28.75 per share, the 60,000 shares referred to above. When such offering was made shortly thereafter it was subscribed in full. (R. 34.)

On or about April 13, 1937, a representative of the several underwriters delivered to Bankers Trust Company (the stock transfer agent) checks drawn to the petitioner's order in the aggregate amount of $1,725,000. Simultaneously therewith, Bankers Trust Company delivered a check for $150,000 for services rendered by the underwriters in connection with the offering of stock to the public. (R. 34–35.)

Immediately after the sale of this stock, the petitioner owned 108,936 shares of the common stock of Western Auto which he held for investment with a view to collecting dividends therefrom and to realize gain if subsequently sold. The petitioner also sold his shares of Western Auto stock and paid the commissions to the under-

writers for their services in order to obtain the best possible price for such stock. (R. 35.)

In computing capital gain for his 1937 tax return, the petitioner did not reduce the sales price or increase the cost basis of the stock sold by subtracting the $150,000 paid to the underwriters as commissions and the $5,000 paid as his allocated part of the cost of the registration. Instead, he claimed both sums as deductions in computing ordinary net income. It is agreed that the cost basis of this stock is $368,770; and if the $155,000 is deductible as an ordinary and necessary non-business expense incurred in the production of income or in the management of property held for the production of income, the amount of the capital gain resulting from the sale of the stock is $1,356,230. But if the sum of $155,000 is either a part of the petitioner's cost or an offset against the sales price in computing his capital gain, it is agreed that the amount of capital gain resulting from the sale of the stock is $1,201,230. (R. 35–36.)

On June 3, 1937, because of the sale of stock by the underwriters to the general public, Western Auto stock was admitted to listing on the New York Stock Exchange. Such listing increased the marketability thereof, for on January 6, 1937, there were only 780 holders of the stock of Western Auto whereas at the close of business on January 29, 1938, there were 2,174 holders of the new stock. (R. 36.)

The Tax Court held that the sums of $150,000 and $5,000, referred to, are not deductible as ordinary and necessary nonbusiness expenses incurred for the production of income. Accordingly, it decided that there is a deficiency in income tax for 1937 in the amount of $86,489.24. (R. 40).

The decision of the Tax Court was affirmed (R. 56–57).

ARGUMENT

The petitioner asserts the right to deduct the sums involved here as nonbusiness or nontrade expenses under Section 23 (a) (2) of the Revenue Act of 1936, as retroactively amended by the Revenue Act of 1942 (Appendix, *infra*, p. 11). Under that Section, expenses must not only be paid or incurred, as petitioner contends, for the production or collection of income, or for the management, conservation or maintenance of property held for the production of income, but such expenses must also be "ordinary and necessary expenses."

The term "ordinary and necessary expenses" has appeared in the provisions of all of the revenue statutes allowing the deduction of business expenses and its meaning was well established before 1942. Thus it had been authoritatively settled, before the enactment of Section 23 (a) (2), that such term does not include capital expenditures and that expenses like those here are capital expenditures. As to commissions, see *Spreckels* v.

Helvering, 315 U. S. 626; *Helvering* v. *Winmill,* 305 U. S. 79, and *Helvering* v. *Union Pacific Co.,* 293 U. S. 282. Also see Article 24–2 of Treasury Regulations 94 and G. C. M. 15430 (Appendix, *infra,* pp. 14–15, 17–20). As to registration costs, see *Motion Picture Capital Corp.* v. *Commissioner,* 80 F. 2d 872 (C. C. A. 2d), and I. T. 3026, XV–2 Cum. Bull. 83 (1936).

In using the term "ordinary and necessary expenses" in Section 23 (a) (2), Congress did not enlarge or change its generally accepted meaning. *Bowers* v. *Lumpkin,* 140 F. 2d 927 (C. C. A. 4th), certiorari denied, 322 U. S. 755. In enacting that Section, Congress was adopting a proposal of the Treasury Department "to afford relief for a specifically defined inequitable situation which had become manifest" by the decision in *Higgins* v. *Commissioner,* 312 U. S. 212, and definitely intended the amendment to be "for the restricted purpose which originated it." *McDonald* v. *Commissioner,* 323 U. S. 57, 61, 62.

This is further shown by the legislative reports on this amendment in which it was specifically pointed out that a deduction thereunder would be subject, except for the requirement of being incurred in a trade or business, to all the restrictions and limitations that apply in case of a deduction under the section covering business expenses. See H. Rep. No. 2333 and S. Rep. No. 1631 (Appendix, *infra,* pp. 16, 17). Consequently, as this

Court stated in *McDonald* v. *Commissioner,* 323 U. S. at p. 62, the 1942 amendment "merely enlarged the category of incomes with reference to which expenses were deductible." It does not permit the deduction of capital expenditures.

In urging such a radical departure in the interpretation of the term "ordinary and necessary expenses," the petitioner relies on *Trust of Bingham* v. *Commissioner,* 325 U. S. 365, with which he asserts a conflict here. That case involved certain legal expenses which the Tax Court found to be ordinary and necessary expenses for the management or conservation of the trust property; and the question on appeal was whether such expenses were incurred for the production of income or in the management of property held for the production of income. In holding that the expenses were so incurred, this Court specifically pointed out that to be deductible under Section 23 (a) (2) they must be ordinary and necessary expenses. It also stated (pp. 373–374) that Section 23 (a) (2) is "comparable and *in pari materia*" with the provision authorizing business expenses, and that "the effect of section 23 (a) (2) was to provide for a class of non-business deductions coextensive with the business deductions." We submit that the decision of the court below is not in conflict with the *Bingham* case.

Petitioner also asserts a conflict with *Heller* v. *Commissioner,* 147 F. 2d 376 (C. C. A. 9th), cer-

tiorari denied on another issue, 325 U. S. 868. It was held there that attorneys' fees paid in connection with a suit for the cash value of certain stock were deductible under Section 23 (a) (2), here involved. However, such fees were not treated as capital expenditures; the Tax Court had found that the suit was not one to defend or assert title to property, but was for the production or collection of income. The Circuit Court of Appeals treated the question as one of fact, and having accepted the findings of the Tax Court, it affirmed the latter's decision to permit the deduction. Accordingly, in view of the findings of the Tax Court in that case, there is nothing in the holding in the *Heller* case essentially in conflict with the decision here.

Petitioner's alternative argument that the underwriters' commissions and the registration fees were ordinary and necessary expenses within the meaning of Section 23 (a) (2) "because incurred in connection with the management of property [the retained shares] held for the production of income" (Pet. 5) is, at best, a strained attempt to avoid the essential capital nature of the expenses of sale by attributing those expenses to the marketability of the retained shares and assuming, without discussion, that, so viewed, they were not capital expenditures. Even if sound, this contention can afford no aid to the petitioner here since he has laid no foundation

for the proration of expenses which would undoubtedly be required. Cf. *Helvering* v. *Stormfeltz,* 142 F. 2d 982, 984–985 (C. C. A. 8th).

CONCLUSION

For the foregoing reasons, review by this Court is not warranted.

Respectfully submitted.

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FEBRUARY 1946.